DOW THEORY LETTERS INC.

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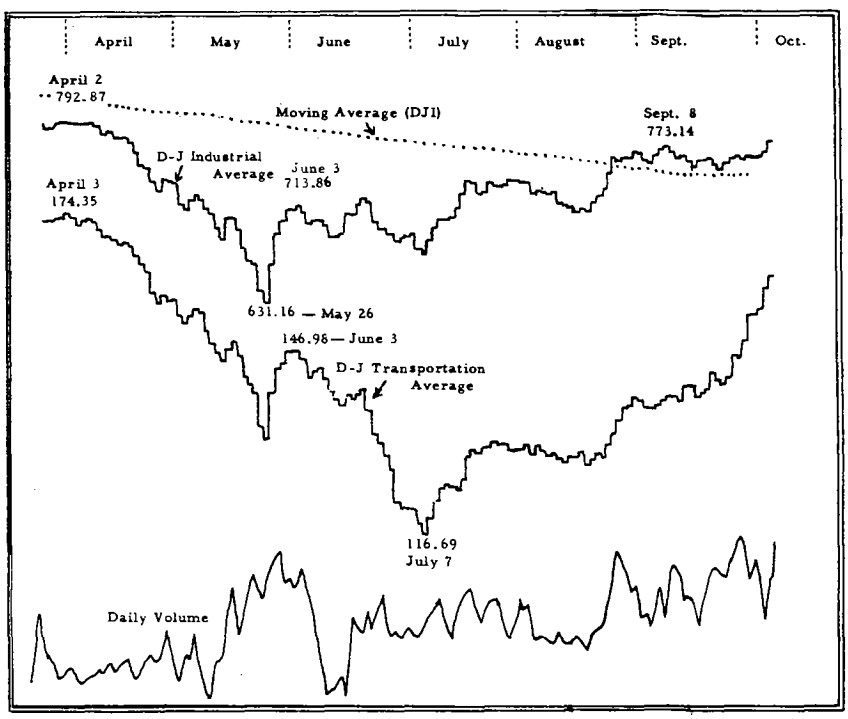
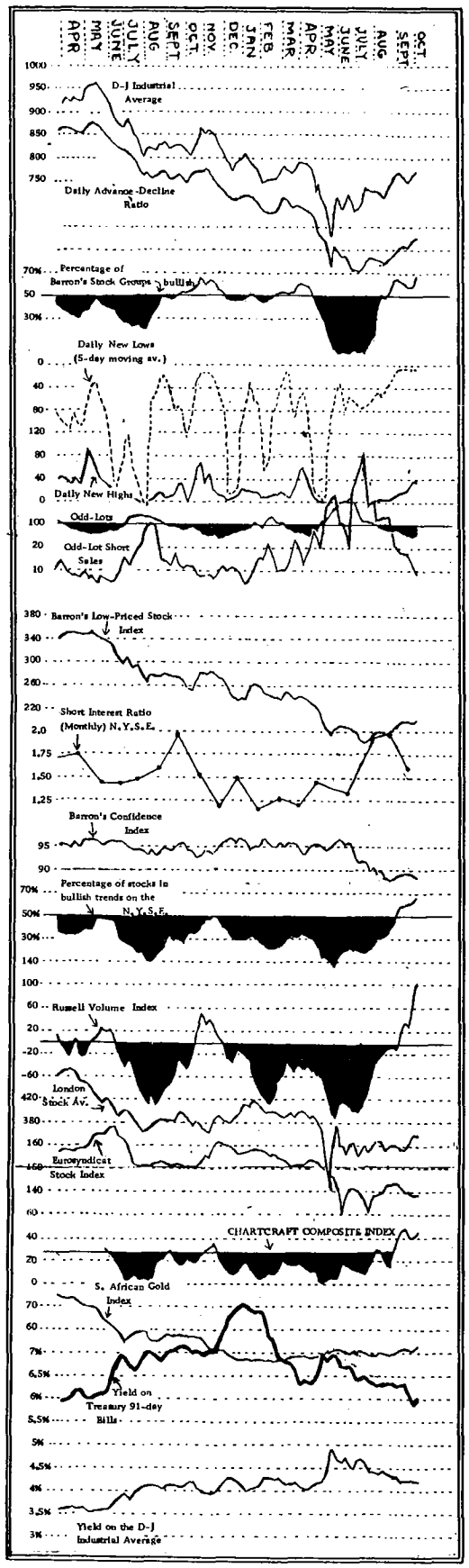
THE MARKET: The timing of this particular mailing is rather difficult, and I have therefore decided to write much of the market section towards the end of this Letter rather than at the usual beginning. In short, however, the Transportation Average on September 28 pushed above its June 3 peak of 146.98, thus belatedly confirming the earlier (actually June 19) performance of the Industrial Average (in which it rallied above its own June 3 peak). All this is shown on the lower chart on this page.

In the meantime, Industrials recorded a recovery high of 773.14 on September 3. And despite a surge of strength on the part of Transports, the Industrial Average has (at this writing) been unable to better its 773.14 peak. Thus, the Industrials proved the strong Average from the May 26, 1970 low of 631.16 to the September 8 peak of 773.14. During all that time Transports had failed to confirm. Following September 8, the Transports proved to be the strong Average, from then on it was the Industrials which would not confirm.

The question is, what would it mean if Industrials now rally above their 773.14 peak? In brief, it would mean only that the current secondary (upward) correction in the bear market is to be extended. I have written repeatedly that primary bear markets undergo three psychological phases. I have stated that we are currently in the long, usually deceptive, second phase. With the recent Transport confirmation on the upside (September 28), many analysts have announced that "the Dow Theory has rendered a bull signal". This is nonsense. There is a great deal more to Dow's Theory than mere mechanical configurations in the Averages. But the curcial thing to





remember is that it is only during the third and final phase of a bear market that a reversal of the primary trend is to be expected.

As Robert Rhea pointed out so many times, during the third phase when high-grade stocks are selling at great values, when speculation has died out, when volume is extremely low, when pessimism rules Wall Street and Main Street, it is then that the Dow Theorist begins accumulating in anticipation of a new bull market. Following such a period, when the Averages rally, correct, then push above their initial rally peaks (thus providing a true bull signal) the Dow Theorist knows that the primary trend has reversed and that his purchases were correct and well warranted. The Dow Theorist may double up or triple up on his commitments following the bull signal, but most importantly, all the characteristics of a major bear market bottom were already there during the buying period.

I might note that here, following a false "bull signal" in the averages we are witnessing record volume, we see rampant speculation (only five months after the May 26 low), we find optimism regarding the economy, we note that the low priced stocks and glamor and speculative issues are flying.

I might also add that we find the yield on the Dow Industrials at 4.20% (Barron's, October 5, page 58) and the yield on the Dow 40-Bond Average at 9.11%. This provides an inverse (negative) yield spread of 4.91% in favor of bonds! Rather a heady way to start off "a new bull market". If the two yield figures were reversed, then I would be a good deal more impressed.

In closing this section I want to write a bit about the dynamics of rallies and declines in a primary bear market. People forget that the function of the Averages is to discount, to move before the events. When a primary bear swing gets under way, there may be little in the way of pressing adverse news in the air. This is the reason why a massive collapse such as the 1969-70 affair is termed "crazy", "overdone" or "without reason" in the press at the time. Such a move is usually discounting negative factors which for some incredible reason always seem to appear in full force near, at or around the bottom of the bear leg.

Then, with the pessimistic news suddenly making the headlines, with shorts pouring "bravely" into the market, the upward correction comes. The correction may seem just as absurd. "How can the market be rallying in the face of this awful news?" asks the public. But the rally is purely technical. What has occurred is that the primary downswing has fully discounted the bad news, the bad news emerges, and the market surges as it seeks to correct the preceding bear leg.

A good exercise is to go back and read the newspapers of late May and June. After arguing with the Averages all the way down during 1969 and 1970, around May and June everyone finally turned bearish and everyone was coming up with the fundamental reasons for the decline. Now, with the Industrial Average back in the 760 area, people are turning bullish again. They are claiming that the "liquidity crisis" is over and that the Vietnam and Mid-East pictures will "work out", that Mr. Nixon and the Administration are getting everything in hand, that the budgetary and monetary scenes aren't too bad. When this euphoria reaches its height we can expect the next major primary downswing to get underway. This may come in a week or a few months.

There is no way of "measuring" the exact height of euphoria, but we can be sure, when the next bear leg comes, that it (1) will seem crazy and overdone, (2) will carry far further than seems warranted by conditions, (3) will terminate at about the time that the news turns black and around the time that the short sellers are fearlessly shorting the market.

BIG SWEEP: I am taking up a whole page (page 3) to reproduce my own wall chart. This chart traces the weekly high and low of the D-J Industrial, Transportation and Utility Averages from the inception of the primary bear market in February, 1966, to the present. The chart is drawn to semi-logarithmic proportions so that it measures all movements in percentages. Thus a rise from 110 to 220 on the Transports will show as exactly the same distance as a rise from 500 to 1000 on the Industrials. In both cases, the Averages would have risen 100%.

As one studies the chart it is immediately apparent that the Transports have taken the greatest percentage loss in this bear market. From their 279.88 all-time high of February, 1969, Transports smashed to a bear market low of 116.69 on July 7, 1970. This represents a total loss of 58% in the price of the Transportation Average. This is the worst percentage collapse in any of the Dow Averages since 1937. At that time the old Rail Average dropped from a March peak of 64.46 to a March, 1938 low of 19.68. That was a one-year loss of 74% for the Rails!

Industrials have suffered a considerably lesser loss than Transports. From their February, 1966 peak of 995.15, Industrials struck a May, 1970 low of 631.16. This represents a total loss of 36% for the senior Average.

Finally, the Utility Average has suffered a drop from the April, 1969 peak of 163.32 to the 1970 (May) low of 95.86. This is a loss of almost 42% in the price of the reputedly decline-resistant Utility segment. The 1965 to 1970 loss was the worst for Utilities since the 1939 to 1942 loss (27.10 to 10.58). That drop wiped out 61% of the price of the Utility Average.

I have reproduced this chart because I feel it provides the best picture of the whole sweep of the bear market so far. Often a chart can give one a "feel" for the market which no amount of words or descriptions can match. As I see the picture, the Industrials are now tending to "churn" as they move into the area of their first-quarter, 1970, levels. The Transportation Average, following its crushing 1969-70 collapse, has barely started to correct its drastic losses. And the Utility Average is still considerably below its first-quarter, 1970 highs.

The majority of services are now proclaiming "a new bull market". From my observations, they are basing this view partly on short-term technical considerations and partly on hopes. In my opinion, when the short-term technical factors weaken (and a few of them are now weakening) the major forces of the primary bear trend will again take hold . The next downward

move could be much more drastic and persistent than anyone now envisions. The severity of the decline will be heightened by the rampant counter-trend speculation which we have been witnessing over the past few months.

DOW SHORT INTEREST RATIO: This is the indicator developed by William Gordon of New York, and as far as I know, only Dow Theory Letters reviews this indicator regularly with accompanying historical charts. I guess I have been lax because I last reviewed the DSIR back in May (Letter 461). I consider the DSIR one of the most important technical tools for gauging the direction of the primary trend.

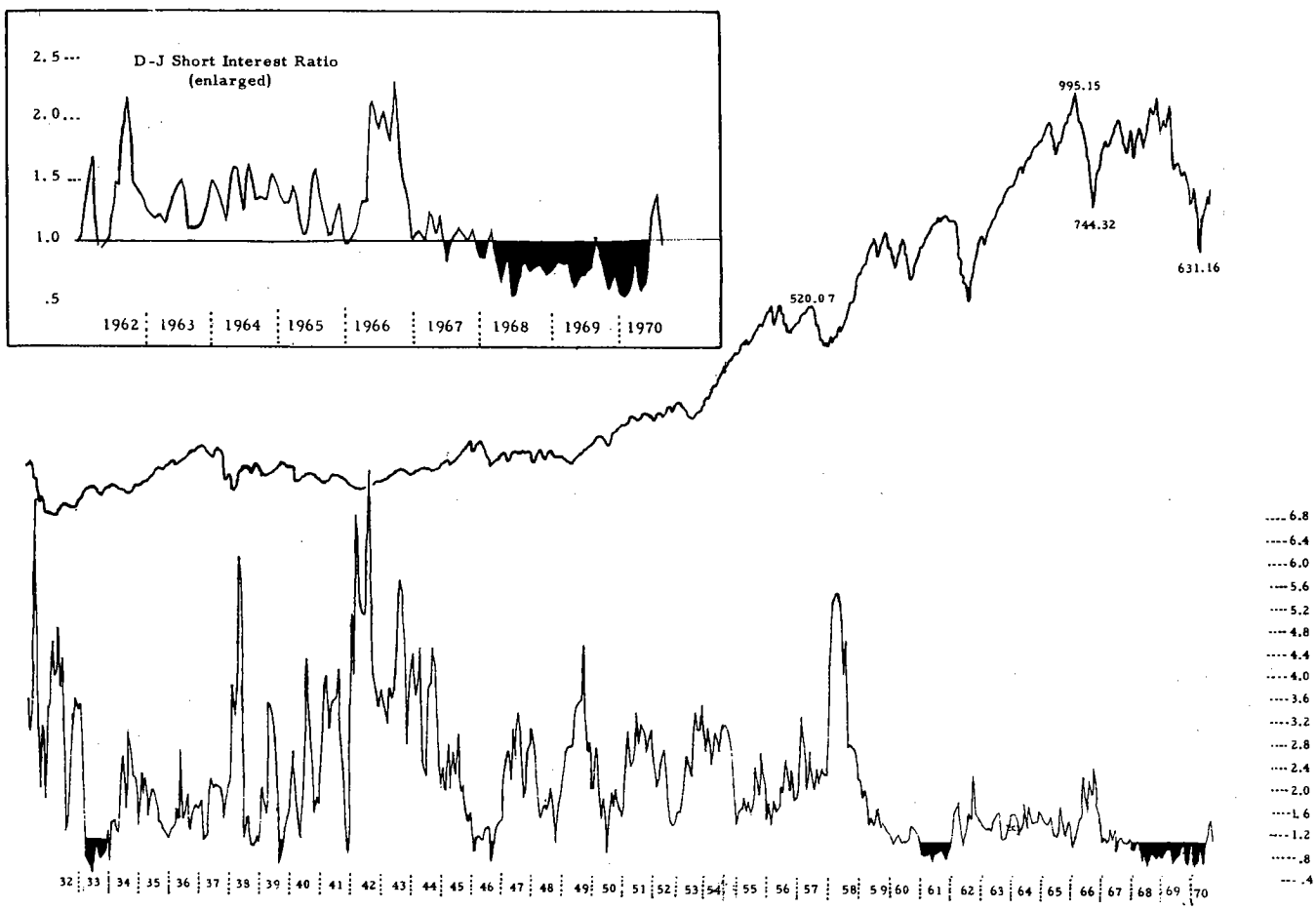
I include a long-term chart showing the monthly DSIR figures from 1931 to the present with the Dow Industrials superimposed for comparison purposes. The small insert is simply a blow-up of the DSIR covering the figures from 1962 to date.

I place particular stress on the DSIR because (1) it gives buy and sell signals only rarely, (2) it has a very limited following, (3) it has an impressive record of being correct when properly interpreted. In general, buy signals are given when the DSIR climbs above 1.5 (preferably 2.0). Sell signals are given when the DSIR drops below 1.0. As a rule, the longer the DSIR remains in the buy or sell area, the stronger the signal.

I have marked the sell areas (DSIR under 1.0) in solid black. Since 1931 there have been four minor (smaller) black sell areas and three major (large) black sell areas. The first major sell area occurred in 1933, and this was accompanied by the panic that year. The second major sell signal occurred when the DSIR held below 1.0 for thirteen consecutive months starting with January, 1961. This was accompanied by the 1962 cave-in which took the Dow from 734 to 535.

The third major black sell area began in January, 1968, when the DSIR fell to .85. In the 33 months since then, the DSIR has held under 1.0 in all but three months. During August, 1969, the DSIR rose to 1.04, then sank under 1.0 again the following month. In July, 1970, the DSIR rose to 1.19 and in August it moved to 1.40. Last week I received a letter from Bill Gordon reporting that the total short interest in the 30 Dow stocks dropped from 1.07 million in August to .91 million in September. With volume up, the DSIR sank below 1.0 again to a September figure of .96.

Thus, on the latest reading we can say that the DSIR has held under 1.0 for 30 out of the past 33 months, an all-time bearish record. A further examination of the chart shows that no past major advance ever was ever associated with the DSIR under 1.5.



For instance, to go over some recent history, the 1962 rise started with the DSIR at 2.19 in October, 1962. The 1966 massive upward correction got started with DSIR readings of 2.14 in June, 1966, 2.05 in August, 2.33 in October.

The 1.40 reading of August, 1970, was the highest reading since 1966, but it was still not a very high reading. The latest (September) reading of .96 again took the DSIR to bearish territory, and I think it will be most important to see whether the current rise has run additional shorts out of the Dow stocks as we wait for the October figures.

In conclusion, I would say that no primary advance was ever mounted from the type of DSIR action we have seen over the past few months.

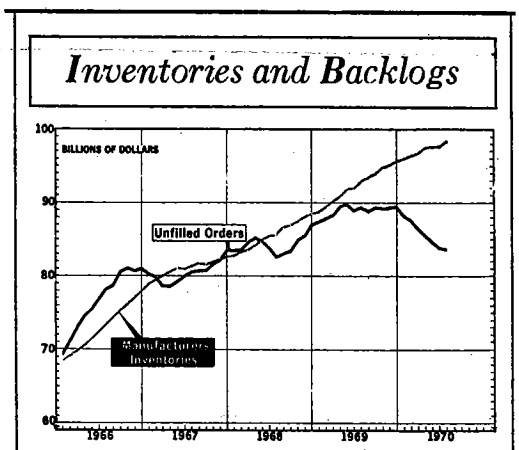
FUNDAMENTAL TROUBLE: Amid all the fanfare and promises of the Administration, one group of statistics has managed to be largely overlooked. This is the group which covers new orders and inventories. If you are running a business, your most fundamental statistics are the ones showing new business coming in, back-orders to be shipped and the amount of inventory you have to cover orders and incoming orders.

The 1970 figures so far hardly suggest a resumption of economic activity as has been "announced" by so many economists. I am including this little chart from the Wall Street Journal showing the paths of unfilled orders and inventories since 1966. The unfilled orders on manufacturers' books dropped in July (the latest reporting period) to $83.8 billion from $84 billion in June. In January, 1970, unfilled orders were near $90 billion.

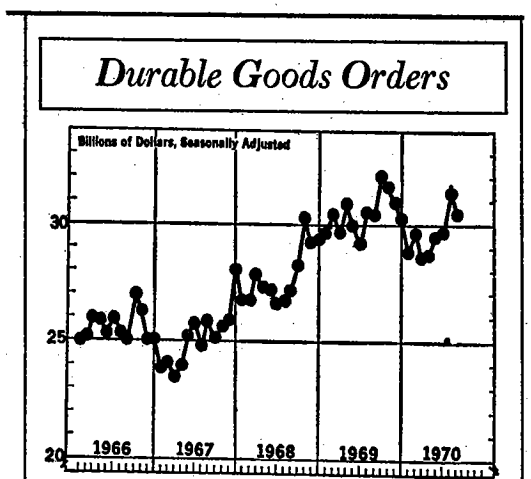
Now the amazing thing is that during this same period inventories have been building. In April, 1970, inventories were $97.7 billion, in May they rose to $97.9, June saw a slight dip to $97.7, and in July inventories rose to a peak of $98.5 billion. Thus, as the order backlogs shrink, inventories continue to build. What this means is that shortly manufacturers will have to cut back sharply on inventories just to get them in "trend" with unfilled orders. But if unfilled orders continue to drop, the inventory cutting could become drastic by year's end.

The Government runs another set of figures termed durable goods orders. These are new factory orders for durable goods, and analysts consider these a key indicator of coming economic trends. The latest August figure shows new orders for durable goods down 3.3% in August to $30.3 billion from July's $31.4 billion. This put the August figure below the $31.4 of a year ago. All in all, the way the statistics are coming in, I would guess that factory production is going to run into trouble between now and 1971. And businessmen who have optimistically been building their inventories (or not cutting them fast enough) are going to be surprised at how costly all that excess inventory is going to be.

LATE MARKET NOTES: Following a classic bear market bottom, it is characteristic of the first (upward) primary bull leg to be slow, steady and persistent against a background of black economic, social and political news. There is little speculation during the first bull leg, for the buying here is of the highest investment caliber. In fact, there is usually so little



INVENTORIES of all manufacturers in July rose to $98.5 billion from $97.7 billion the previous month. Unfilled orders decreased to $83.8 billion in July, after seasonal adjustment, from $84 billion in June.



NEW ORDERS received by manufacturers of durable goods fell in August to a seasonally adjusted $30.4 billion from a downward revised $31.4 billion a month earlier, the Commerce Department reports. (See story on page 3.)

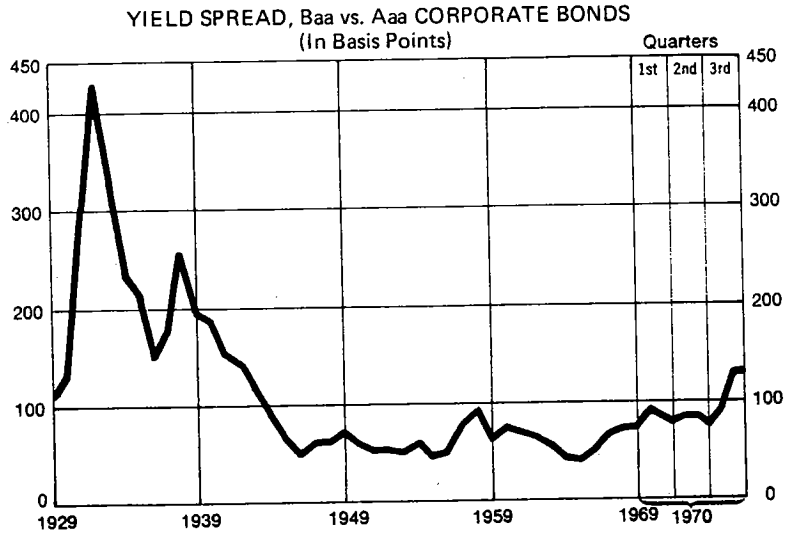
speculation and so little volume that the first leg of a new bull market can be completed almost unnoticed by the public.

Compare that picture with the sudden rush of enthusiasm which is accompanying this leg up from the May 26 low of 631.16 for the Dow Industrials. The Administration has tried everything possible to turn the public bullish. Every scrap of optimistic news and every up-tick in the economic indicators has been broadcast throughout the nation. The Federal Reserve Board, its actions watched with microscopic intensity, has opened the floodgates of the money supply. Brokerage houses from Coast to Coast have proclaimed a "new bull market" in their advisory letters. And volume on the N.Y.S.E. has boomed while the market is only five months from its last bear market bottom.

"Boomed" is hardly the word for it. For instance, the two days of September 24 and 25 produced volume of 21.34 and 20.47 million shares respectively or a two-day total of 41.81 million shares, the biggest two-day total on record. Volume is Wall Street's biggest advertising device, Here in October the advertising is loud and clear that a new bull market is underway and you better get in and get yours before it is too late.

I'm afraid that the result of all of this hoop-la is going to be very much like the debacle of 1969 and 1970. When this correction in the primary bear market runs out of gas, the primary bear forces are going to take hold bigger than ever, and the aftermath is going to be a smashing decline to new lows for the bear market.

I noted previously that so far in the bear market the big volume has been on the upward corrections. The damage during 1969 and '70 was severe, but at no time did volume measure anything like the upside volume of 1967 and 1968 or anything like what we are seeing now. Again I will predict that before this bear market is over we are going to see huge and expanding volume on the downside as the speculators are crushed again and as the public is handed its third major beating following 1966 (the first down-leg) and 1969-70 (the second down-leg of the bear market).



To my mind the technical underpinnings of this rally are considerably weaker than those which preceded the rally which carried from late-1966 through to late-1968. The Dow Short Interest Ratio started with lower readings, the technical damage to individual stocks was much worse during 1969-70 than during 1966, the odd-lot short index was lower during 1970 than during 1966, the stock-bond yield (negative) spread is much more bearish here in 1970 than it was in 1966.

Alan Abelson (Barron's of Oct. 5, page 25) notes that corporate liquidity (ratio of cash assets to current liabilities) fell to 17.5% (a new low) through the second quarter of 1970 from a first quarter 18% and a skimpy 21% a year earlier. With liquidity at crisis levels, we can expect a continued flood of new bond and stock issues as corporations seek to bolster their balance sheets with new money, and such issues could reach floodtide during the rest of 1970 and 1971.

Meanwhile, the spread between Baa medium-quality and Aaa quality bonds continues to widen as investors' fears are raised regarding the advisability of holding anything but the highest-grade debt. Such fears on the part of sophisticated bond buyers flies in the face of the complacent public which is now flocking into Wall Street to purchase common stock in firms, many of which could be in severe financial trouble before this bear market is over.

I include a chart from Salomon Brothers showing the yield spread between the high-grade Aaa corporate bonds and the lesser-grade Baa bonds. This index is still far from its depression spread of the 1930's, but it is nevertheless on a rising trend and is currently at its highest level since 1942.

LATE, LATE: On Monday, Oct. 5, Industrials closed just above the September 8 previous recovery peak of 773.14. Transports pushed to new recovery highs as well. If this were a primary bull market I would say that further advance was assured. But here in the deceptive second phase of a primary bear market I can only say that the advance will probably carry further, but that bulls and buyers are in there at their own risk. Dow's Theory states that a bear market is still in effect, and that's all I'm interested in at the moment.